Technical Connection

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Published by Technical Connection Ltd,
7 Staple Inn, London, WC1V 7QH.
Tel: 020 7405 1600 Fax: 020 7405 1601
E-mail: host@technicalconnection.co.uk
www.techlink.co.uk

INHERITANCE TAX

The transferable nil rate band
Finance Bill 2008 modifications

Two changes in connection with the transferable nil rate band, which were not announced in Budget, have been made in the Finance Bill 2008 as follows:-

(i) The modifications to the rules to deal with some earlier deaths – for example those occurring in the capital transfer tax and estate duty eras – were to have been set down in regulations but instead are included in primary legislation.

(ii) A modification is made to the conditions that need to be satisfied to claim a part of the unused nil rate band of a deceased spouse where that spouse was himself or herself entitled to a transferable nil rate band because of the death of a former spouse. The background to this change is that, in general, claims for a transfer must be made by the personal representatives of the deceased surviving spouse within 2 years of his or her death. In this context the "deceased surviving spouse" is the spouse who survives the first death.

A maximum 100% of the nil rate band of a deceased spouse is available on the death of a surviving spouse although, subject to the total not exceeding 100%, it can be accumulated on more than one occasion if a person dies having survived more than one spouse.

Under the draft legislation, if A was married to B and A dies, then on B's subsequent death his or her personal representatives could claim any unused portion of A's nil rate band. If B remarries C and then dies, B's personal representatives could claim any unused portion of A's nil rate band. However, if they do not then, on C's subsequent death, C's personal representatives could only claim any portion of B's unused nil rate band which would not include any of A's unused nil rate band.

To deal with this situation an amendment to the draft legislation has been made in the Finance Bill which will enable the personal representatives of C to claim not only any portion of B's unused nil rate band but also any portion of A's unused nil rate band which the personal representatives of B could have claimed but did not. This is subject to the rule that no amount in total can be claimed which exceeds 100% of the nil rate band.

LIFE POLICYHOLDER TAXATION

Company – owned policies
Finance Bill 2008

As announced in the 2007 Pre-Budget Report, the application of the loan relationship rules to all investment-based life insurance policies (largely investment bonds) from 1st April 2008 means, broadly speaking, that gains made under UK and offshore investment-based life policies will be taxed as non-trading credits under the loan relationship rules. For more information on this see our January 2008 monthly bulletin.

Although no mention was made in the Budget of the loan relationship rules, some significant changes to the draft legislation have been introduced in Finance Bill 2008 as follows:

- All life policies effected by a company before 14 March 1989 (and which have not been subsequently enhanced as to benefit or term) were outside the chargeable events legislation and would, in effect, produce a tax free return for the company. As originally drafted the legislation did not distinguish between policies effected on or after 14 March 1989 and those effected before 14 March 1989 which would have brought gains on pre 14 March 1989 policies into the loan relationship charge. The favourable position for pre 14 March 1989 policies has been reinstated in the Finance Bill provided such policies have not subsequently been enhanced.

- Subject to the satisfaction of certain conditions, under the previous legislation an endowment policy effected by a company as part of a commercial mortgage arrangement would not give rise to a chargeable event gain on maturity or the payment of death benefits. The draft legislation made no reference to this rule, nor does the Finance Bill which means that, as things stand, gains on such policies will be brought into charge to tax under the loan relationship rules unless they are pre 14 March 1989 policies which have not been subsequently enhanced.

- Capital redemption policies were for the most part brought within the loan relationships legislation in February 2005. The legislation in the Finance Bill and the draft legislation define an "investment life insurance contract" as including capital redemption policies so that corporately owned capital redemption policies effected before 14 March 1989 will also fall outside the loan relationship rules.

- Under the chargeable events legislation there is a general rule that, in determining the amount of any chargeable event gain on death, the surrender value immediately before death is used and not the sum assured actually paid. The reason for this is to exempt from tax any chargeable event gain arising from a payment made in respect of the life assured's mortality. The Finance Bill maintains this rule for the purposes of calculating the non-trading credit (ie gain) for loan relationship purposes and extends it to critical illness benefits.

- In the loan relationship corporation tax computation for a company that has invested in a UK life policy (or an EEA life company policy suffering a UK equivalent rate of tax) the amount subject to tax under the loan relationship rules has to be increased to reflect the tax suffered at UK life company level, currently 20%. Credit is, however, given on the grossed-up gain at 20% for corporation tax suffered by the life fund. For a policy that is valued by the company on a fair value basis (ie at current value rather than on a historic cost basis) the Finance Bill introduces a special rule to ensure that, on final encashment of the policy, a tax credit is given for the gains chargeable under the loan relationship rules over the whole period of ownership (or the period of ownership from the start of the first accounting period beginning after 31 March 2008 if the policy was owned at that time) and not simply the gain for the accounting period in which the policy terminates.

- When a policy is owned at the start of a company's first accounting period which begins after 31 March 2008, a deemed chargeable event occurs immediately before the start of that accounting period. No tax charge arises then on the chargeable event gain, but it is brought into charge to tax when the policy terminates. In calculating the chargeable event gain, the carrying value in the accounts (either historic cost or fair value) is the consideration for determining the amount of the deemed chargeable event gain. Detailed rules are included in the Finance Bill to prevent inequitable results where the policy has decreased in value or large withdrawals have previously been made.

Whilst the precise ambit of these rules is still being clarified, at the time of writing it would seem that there may well be scope for certain companies to use investment bonds as a means of investing and obtaining tax deferral. We will write further on this subject when the position becomes clearer.

DISCOUNTED GIFT TRUSTS FOR THE VERY

Discounted gift trusts for those age 90 or over
HMRC loses case before the Special Commissioner
HMRC to appeal to High Court.
Revised guidance issued

On 17 May 2007 HMRC issued a technical note on discounted gift trusts (DGTs). In this note HMRC expressed its view that a discount cannot be given for somebody age 90 or more on a true or mortality-rated basis. This is on the basis that, in general, life assurance cover is not available for people who are older than this and it is HMRC's considered opinion that no-one would buy the retained rights (in effect as an annuity) if they could not also buy insurance against the risk of early death of the settlor. If there would, in practice, be no buyer then the settlor's retained rights could have no value. This would mean that there would be no discount. This view was challenged in a case against HMRC brought by the executors of Mrs Bower deceased. The brief facts of the case are:

- Mrs Bower purchased a DGT from AXA Isle of Man in December 2002, when she was nearly 91 years of age, for £73,000. She was underwritten and her age loaded to 103.

- Mrs Bower died 5 months later so there was a chargeable transfer for inheritance tax purposes which fell to be valued.

- AXA valued Mrs Bower's retained rights at £7,800 which would have meant a discount of £7,800 and an IHT saving of £3,120. HMRC initially valued the rights as nil but subsequently at £250. Mrs Bower's executors appealed against this valuation.

An actuary, as a witness for HMRC, argued that in his firm's experience it would not be possible to insure the mortality risk. Taking account of this fact and likely expenses of between £1,000 and £2,000, his firm valued the retained interest at £250.

For the executors it was argued that all that was necessary to determine a value was to assume a sale between willing parties. The monthly payments due were themselves £300 each and Mrs Bower did have a life expectancy of about 30 months which meant a number of £300 payments might be made. An adjustment could be made to the purchase price for the greater risk to a purchaser because of the absence of life cover. On this basis a valuation of £6,277 was put forward after an allowance of £500 for expenses.

The Special Commissioner had to weigh two quite complex actuarial arguments. He felt that speculators would be willing to pay more that £250 because were Mrs Bower to live for her projected life expectancy of 30 months, he calculated a profit of £8,820 would be made by a purchaser. The figure fixed by the Special Commissioner was £4,200 based on two-thirds of £7,800 (the Axa valuation) less £1,000 for expenses (which was about the median).

HMRC has appealed to the High Court against the decision and has issued guidance on how it will value gifts under a DGT pending the outcome of the appeal. Cases currently under review by HMRC will remain under review pending the outcome of the appeal. New cases, which involve lives aged 90 or over (on a true or mortality-rated basis) or those who are uninsurable, will continue to be dealt with on the basis set down in the HMRC technical note on DGT valuations issued on 17 May 2007. Where HMRC considers the value of retained rights to be only nominal the personal representatives will be advised by HMRC that it will not press for payment of extra tax at that time but with a suggestion that an amount for the potential extra tax is lodged with HMRC so as to avoid the accrual of interest on outstanding tax. The position will be reviewed following the outcome of the appeal.

PENSIONS

The last month has been a busy one for pensions, with major developments/announcements amongst others in relation to State pension benefits and the transfer value calculation rules.

State Pension Benefits

The Low Earnings Threshold for the State Second Pension (S2P) for tax year 2008/09 has been set at £13,500. The Low Earnings Threshold is a key component in determining the accrual of benefits under the S2P, which will be as follows for tax year 2008/09.

Earnings	S2P Accrual Rate
£4,680 (Lower Earnings Limit) - £13,500 (Low Earnings Threshold)	40%
£13,500 - £31,100	10%
£31,100 - £40,040 (Upper Earnings Limit)	20%

For those individuals who have earnings in excess of the Lower Earnings Limit but less than the Low Earnings Threshold, their S2P benefit in tax year 2008/09 will be deemed to accrue on the assumption that their earnings are at the Low Earnings Threshold (ie. £13,500).

Transfer Calculation Basis

Following its lengthy consultation the Government has now issued The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 – SI 2008/1050, which set out the new transfer value calculation rules to apply with effect from 1 October 2008.

The main changes introduced by these Regulations are:

- Trustees (scheme managers, where appropriate) will be responsible for calculating cash equivalents.
- The method of calculation in the Regulations sets the minimum amount for the cash equivalent, although trustees can pay higher amounts if they wish.
- Trustees will be required to determine the assumptions to be used in the calculation on a 'best estimate' basis.
- Trustees will, as currently, be able to reduce the cash equivalent where a scheme is underfunded.
- Trustees will be able to reduce the cash equivalent to recover any 'reasonable administration costs' in carrying out the transfer.
- Members considering whether to transfer will be told where more information is available to help them make their decision.

We have produced an analysis of these new calculation provisions, which can be purchased on request to David Redfern at our office.

New Regime Changes

The Government announced a change in the 2007 Pre-Budget Report regarding the calculation of a member's tax-free cash entitlement where he/she has a protected tax-free cash entitlement under a scheme. This change is now set out in the Finance Bill 2008.

Prior to the introduction of this legislation the accepted wisdom had always been for a member with protected pre A-Day cash under a scheme to pay, where allowed, at least a further £1 contribution. The aim was to bring the ALSA calculation into play, potentially generating an additional tax-free cash sum.

The changes being made in the Finance Bill 2008 now call for a different strategy. If fund growth since A-Day has not kept pace with the increase in the standard Lifetime Allowance, paying further contributions to the plan will make no difference to the cash entitlement until fund value exceeds the A-Day figure, revalued in line with the standard Lifetime Allowance. Only once this threshold is passed does the ALSA calculation result in more cash (ASLA can never be negative). In contrast, a contribution to another plan will always generate 25% PCLS. Consider the following example.

Example

As at 5 April 2006, Brenda had an old EPP with a value of £50,000 and protected cash of £14,000. No further contributions have been made to the plan on or after 6 April 2006. She now wishes to draws her benefits. The plan is currently worth £51,000. Under the Finance Bill 2008 rules she will receive a maximum allowable PCLS of £15,400, calculated as below:

£14,000 x (£1,650,000 / £1,500,000) + 25% x [£51,100 - £50,000 x (£1,650,000 / £1,500,000)] = £15,400 In this case the growth under her EPP (2%) has not kept pace with the increase in the standard Lifetime Allowance (10%), meaning there is no additional cash arising from the ALSA element of the calculation (in the square brackets).

If Brenda were able to pay a further contribution of £4,000 to the plan just before she is due to retire, bringing her fund up to £55,000, this would not increase her tax-free cash entitlement at all. There would still be no additional cash arising from the ALSA element of the calculation: 25% x [£55,000 - £50,000 x (£1,650,000 / £1,500,000)] = £0.

Were Brenda to pay the £4,000 contribution to a separate plan this would have provided an additional £1,000 cash sum.

This change in the Finance Bill 2008 means that where an individual has a protected tax-free cash sum under a scheme and wishes to pay further contributions, the starting point for maximising cash is to make the contribution to a new scheme. A contribution to the existing scheme can never produce more cash than the new scheme, but could produce less.

HMRC issued the latest tranche of amendments to the Registered Pension Schemes Manual (RPSM) on 26 March 2008, and has also provided draft pages of the RPSM clarifying a number of the changes included in the Finance Bill 2008 (including the change to the calculation of protected tax-free cash).

Pensions Regulator

The Pensions Regulator has finalised its code of practice “Dispute resolution – reasonable periods”. This has been laid before Parliament and is expected to be brought into force in May 2008.

General

- The Government set out plans to increase the powers given to the Pensions Regulator to require employers to provide contributions to a pension scheme if the employer’s actions could threaten the security of members’ pension benefits under a DB scheme. The DWP has now issued a consultation on those plans to increase the Regulator’s powers to issue Contribution Notices or Financial Support Directions, where scheme changes or corporate transactions (including bulk transfers) could, in the Regulator’s opinion, threaten the security of members’ benefits.

- In the Autumn of 2001 the Government accepted the recommendations of a review undertaken by Paul Myners that pension fund trustees voluntarily adopt a set of “comply or explain” principles codifying best practice in investment decision-making. HM

Treasury, the DWP and the Pensions Regulator have launched a consultation on updating the Myners principles.

- In its latest update to its report "Pension Trends", covering the position in 2005/06, the Office for National Statistics comments that "pension payments provide only modest levels of annual income for many pensioner households." In 2005/06, 62% of pensioner couples had total pension income (state and private) of less than £10,000, and half of single pensioners had less than £6,000.

  The report reveals that although around two-thirds of pensioner households received private pension income in 2005/06, 40% of pensioner couples, 55% of single men and 61% of single women pensioners received annual private pension income of less than £1,000. For statistical purposes 'private pensions' includes public sector occupational pensions.

  This latest report repeats a picture familiar from earlier editions: the bulk of the pension income of most pensioners is made up of state, rather than private, benefits. While the average pensioner couple had state pension and benefits worth £7,296, their average income from private pensions was only £2,115 (22% of total pension income).

THE 10% TAX BAND

Some specimen tax calculations

The 10% tax band has been in the news recently for a number of reasons. We thought that some specimen tax calculations would help illustrate the change in the application of the 10% tax band introduced in the recent Budget, bearing in mind that until 6 April 2008 the 10% band could apply to non-savings income and savings income whereas from 6 April 2008 the 10% band will only apply to savings income.

This means that in connection with the 10% band there is now a very relevant distinction between savings income and non-savings income. Savings income is comprised principally of interest and chargeable event gains on life assurance policies, and non-savings income employment earnings, pensions and rental income. Dividend income is in a class by itself.

It is important to note that the 10% band can only apply to the extent it has not been used by non-savings income. In this connection the key is that in the ordering of income in a tax calculation non-savings income is taken first, then savings income and then dividend income. To the extent that non-savings income falls within the 10% band, it will still suffer basic rate tax at 20%.

The following 3 tax calculations illustrate these principles. All examples are for the tax year 2008/09 and based on a single individual aged under 65.

		£
(i)	Building society interest gross	2,000
	Dividends (grossed-up)	100,000
		102,000
	Less: Personal allowance	5,435
	Taxable income (all dividends)*	96,565
	Less: Basic rate band	36,000
	Higher rate tax due on	60,565
	Tax payable at 22½%	13,627

* Building society interest, as savings income, takes the first £2,000 of the personal allowance of £5,435.

		£
(ii)	Earnings	4,000
	Building society interest gross	2,000
		6,000
	Less: Personal allowance	5,435
	Taxable income (interest)*	565
	Tax payable at 10%	56

* None of the earnings uses the 10% band so it is available for the savings income (ie. the building society interest) that is not covered by the remaining £1,435 of personal allowance.

		£
(iii)	Earnings	7,000
	Building society interest gross	2,000
	Dividends (grossed-up)	5,000
		14,000
	Less: Personal allowance	5,435
	Taxable income	8,565
	Tax payable on £1,565 earnings (£7,000 - £5,435) at 20%	313
	Tax payable on interest – 10% on £755 balance of 10% band (£2,320 - £1,565)	76
	Tax payable on £1,245 interest @ 20%	249
	Dividends all within basic rate band	NIL